In the Supreme Court of the United States

OCTOBER TERM, 1924

WILLIAM H. EDWARDS, COLLECTOR OF INTERNAL REVENUE, petitioner
v.
ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND Edmund Coffin, as Executors of the Estate of James Douglas, Deceased

No. 524

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

STATEMENT OF THE CASE

This cause is before this court on a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit to review a judgment reversing a judgment of the United States District Court for the Southern District of New York, dismissing the complaint upon the merits.

The action was brought to recover the sum of $173,579.72, additional income tax assessed against respondents upon the income of their testator, Dr. James Douglas, for the year 1917, and paid by them under protest. The additional tax sought to be

recovered was levied upon two cash distributions received by Dr. Douglas from Phelps Dodge Corporation, in September and December, 1917.

The case was tried in the District Court before Honorable Julian W. Mack, Circuit Judge, and a jury of one, upon an agreed statement of facts and documentary evidence introduced by both parties. Upon the trial respondents, while claiming that the distributions in question were returns of capital to their testator and not income, asserted the further claim that even if such distributions should be held to be income, they were not taxable at the rates prescribed for the year 1917. At the close of the testimony each side moved for the direction of a verdict, upon which motions decision was reserved. Thereafter the learned District Court directed a verdict for the petitioner, and upon this verdict a judgment dismissing the complaint upon the merits was entered. *Douglas* v. *Edwards*, 287 Fed. 919.

Respondents then sued out a writ of error to the United States Circuit Court of Appeals for the Second Circuit. Upon the argument in that Court respondents again urged that the distributions in question were returns of capital to the taxpayer, and not income, and that even if held to be income were not taxable at 1917 rates. The Circuit Court of Appeals held that the distributions were not returns of capital, but were income and taxable as such under the Revenue Act of 1917 (Act of October 3, 1917, c. 63, 40 Stat. 300), but that under

Section 31 (b) (*Id.* 338), of that Act the same were taxable at 1916 and not at 1917 rates. The judgment of the District Court was therefore reversed, and it is to review this judgment of reversal that the present writ has issued. *Douglas* v. *Edwards*, 298 Fed. 229.

THE FACTS

The facts disclosed by the record material to the issues here involved are as follows:

For many years prior to April 1, 1917, respondents' testator, Dr. James Douglas, had been a stockholder (p. 27) in Phelps Dodge & Company, Inc., a New York Corporation, engaged in the business of mining copper and coal through various subsidiaries (p. 29). On April 1, 1917, an internal reorganization of the business took place (pp. 27–29), and in this reorganization the parent company, Phelps Dodge & Company, Inc., was dissolved, and one of the subsidiaries changed its name to Phelps Dodge Corporation and itself became the parent company. The stockholders, including Dr. Douglas, exchanged their stock in the old company for stock in the new, share for share, and the business was continued as formerly. It is agreed by both sides that this reorganization was a mere change of form and that for the purposes of this case the parent company and its subsidiaries may be treated as one enterprise, and the new parent company as a continuation of the old. For clearness therefore the company will hereafter be referred to as Phelps Dodge Corporation, it being

understood that under this name will be included the various subsidiaries and the old company.

On March 1, 1913, Phelps Dodge Corporation, according to a provisional valuation made by the Bureau of Internal Revenue in 1920, and as found by the District Court, had total assets of $153,275,606.69 (p. 24), of which $45,000,000 represented capital stock, $45,000,000 (p. 35), paid in surplus, and the balance, namely, $63,275,606.69, appreciated and earned surplus, made up of appreciation in the value of the mines and of actual earnings. After March 1, 1913, the company continued to operate and each year in computing its net income for income tax purposes, deducted from its gross income and credited on its books to a depletion reserve, an amount necessary to make good the wasting of the value of the mines due to the extraction of the ores. When the provisional valuation was made by the Bureau of Internal Revenue in 1920 this depletion reserve was revised and increased from $14,416,783.88 at the end of 1917 to $25,837,427.91 (p. 32), and the company's income and excess profits taxes were adjusted accordingly. During the years 1913, 1914, and 1915 the company's earnings over and above its deduction for depletion were $6,373,116.86, $3,643,458.10, and $5,623,523.89, respectively, and its distributions to stockholders $7,425,000, $6,300,000, and $9,000,000, respectively (p. 24), so that the distributions in those years exceeded the earnings by $7,084,901.15, which was paid out of the surplus accumulated

prior to March 1, 1913, as the only fund available for such payment.

In 1916 the company's earnings over and above the depletion deductions fixed by the Bureau aggregated $17,750,621.67 and its distributions amounted only to $14,625,000 (p. 24). There was therefore an excess of earnings over distributions of $3,125,621.67. At the close of 1916 the company had a surplus of $104,316,327.21, composed, as stated above, of a paid-in surplus of $45,000,000 and the balance of earned and appreciated surplus. In 1917 the earnings of the company, after deducting the allowed depletion, amounted to $16,742,487.06 and its regular distributions to $10,800,000 (p. 24). In September, 1917, the Board of Directors attempted to declare what it was pleased to call a "depletion dividend" of $3.00 a share (p. 32). By a resolution adopted at a meeting of the Board on September 13, 1917, a dividend of this amount was declared out of the "depletion account" of the company. The preamble to the resolution declaring this dividend recited that the company yearly in computing its income had deducted therefrom a reasonable allowance for depletion of its mines based upon the value thereof as of March 1, 1913, and that the Income Tax Law and the rulings of the Bureau of Internal Revenue provide for a separation of this deduction from income and that payments therefrom to stockholders should be a return of capital and not subject to income tax in their hands. The purpose of the resolution was clearly

to make a capital distribution and to relieve the stockholders from income-tax liability thereon.

The distributions directed by this resolution were accordingly made and Dr. Douglas received the sum of $123,150 as his proportionate part thereof (p. 32). On December 13, 1917, by a similar resolution another " depletion dividend " of $5.00 a share was declared and upon this distribution Dr. Douglas received the sum of $205,250 as his proportionate share thereof (p. 33). These distributions were not treated upon the books of the company like ordinary dividends, but were carried through a series of special accounts fully set forth in the record but not material to the questions here presented (p. 35).

The result was that the company with net earnings for the year of $16,742,487.06 distributed to its stockholders either by dividends declared by resolutions in the usual form or by the so-called " depletion dividends " $14,400,000. At the close of the year 1917 the company had a surplus of $106,658,814.27 (p. 24). Furthermore as found by the District Court (p. 23) the earnings of the company for the year 1917 over and above all previous distributions were sufficient at the time of the declaration and payment of these " depletion dividends " to pay the same. This finding is apparently not disputed by respondents.

In filing his income tax return for the year 1917, Dr. Douglas did not include as part of his income subject to tax the amount of the so-called "deple-

tion dividends" received by him. He did, however, annex a statement to his return showing that he had received $328,400 as his proportionate share of these distributions (p. 77). Upon audit of his return the Commissioner of Internal Revenue included this sum in his income and assessed an additional tax thereon at the rates prescribed by law for the year 1917 (p. 36). Dr. Douglas having died, this additional tax was paid by respondents, his executors, to petitioner under protest, a claim for refund of the same was duly filed and rejected, and subsequently this action was brought to recover the same.

A consideration of the record discloses certain other facts which have a bearing upon the issues here presented. In the first place Dr. Douglas returned all the dividends received by him from Phelps Dodge Corporation, except the so-called "depletion dividends" and the one declared and paid by the company in March, 1917, as taxable at 1917 rates (p. 75). The company treated all dividends, except the March dividend and the so-called depletion dividends, as having been paid from 1917 earnings, and did not reduce its invested capital for excess profits tax purposes by the amount of any such dividends. In the annual report by Phelps Dodge Corporation to its stockholders, dated February 28, 1918, it is said (p. 55):

> Of these dividends, as pointed out in a statement to stockholders under date of January 29, 1918, the dividend paid in March,

> 1917, was paid by Phelps Dodge & Company and was declared and paid entirely out of the profits accrued during the year 1916. The other three regular dividends and extras were paid by Phelps Dodge Corporation out of earnings for the year 1917, and the special dividends of September and December were a "distribution from the reserve for depletion."

In failing to include the amount of these depletion dividends in his income for the year 1917 Dr. Douglas took the ground that the same had been declared and paid from the depletion reserve of the company and were therefore returns of capital to him. In the protest filed by respondents the same ground is elaborately set forth (pp. 10–12) and the claim is specifically made that the tax on these depletion dividends is illegal and void since the same were not distributions from the surplus and undivided profits of the company, but were distributions of capital, and therefore not subject to tax as income under the Sixteenth Amendment. In the claim for refund the language of the protest is repeated (pp. 79–82), and the claim is based upon the ground that a tax upon these distributions is a tax upon capital. The complaint is framed upon the same theory. Paragraphs "Twenty-third" to "Twenty-seventh" inclusive (p. 7), base the alleged illegality of the tax upon the claim that the tax is levied in respect to a capital distribution and that the provisions of the Revenue Act of 1917 in so far as they purport to impose a tax thereon are

unconstitutional and void. Nowhere in the record of this case prior to the trial is any claim made that the rate of taxation upon these distributions was erroneous, or that the same if taxable at all should be taxed at any rate other than that prescribed for the year 1917.

At the trial of this case in the District Court the claim was made for the first time that even if these distributions should be held to be income, under Section 31 (*b*) of the Revenue Act of 1917 they could not be taxed at the rates prescribed for the year 1917. The learned District Court held that these distributions were not distributions of capital but were distributions of income and as such were taxable under the Revenue Act of 1917, since a corporation having a surplus and making no reduction in its capital stock can not make a distribution of capital. It likewise held that since the corporation had on hand at the time of the distributions earnings for the year 1917 more than sufficient to cover the same, they were taxable to the stockholder at the rates prescribed by law for that year.

On writ of error sued out by respondents the Circuit Court of Appeals for the Second Circuit sustained the District Court in holding that the distributions in question were income and not capital, but held further that under Section 31 (*b*) of the Revenue Act of 1917, they must be deemed to have been paid out of the surplus which the company had on hand at the beginning of the year, and were

therefore taxable only at the rates prescribed for the year 1916 and not at the rates prescribed for the year 1917. No review of the decision of the Circuit Court of Appeals holding that the distributions were income, and not capital, has been sought by respondents and this point must therefore be taken as settled. The writ of certiorari in the case at bar was applied for in order that the correctness of the construction of Section 31 (*b*) by the Circuit Court of Appeals might be passed upon by this Court.

THE QUESTION PRESENTED

Under Section 31 (*b*) of the Revenue Act of 1917 (40 Stat. 338) are distributions made by a corporation to its shareholders in the year 1917, taxable to the shareholders at the rates prescribed by law for the year 1917, if the corporation has earnings for that year sufficient to pay them, or must they be allocated to the surplus accumulated in prior years and bear the lower rates of taxation prescribed for those years?

SECTION OF THE STATUTE INVOLVED

Section 31 of the Revenue Act of 1916, added by Section 1211 of the Revenue Act of 1917 (Act of October 3, 1917, ch. 63, 40 Stat. 300, 337–338), provides:

> Sec. 31 (*a*). That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, associa-

tion, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income to the amount of the earnings or profits so distributed.

(*b*) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior

to March first, nineteen hundred and thirteen.

ARGUMENT

INTRODUCTION

It is the contention of the Government that under Section 31 (*b*) of the Revenue Act of 1917 distributions by a corporation to its shareholders in the year 1917 must be allocated to the earnings of the corporation for that year, and, if such earnings are sufficient to cover the same, must be taxed to the shareholder at the rates prescribed for that year. It is the contention of respondents, and the holding of the Circuit Court of Appeals, that such dividends must be allocated to the undivided profits or surplus account of the corporation as the same appeared on its books at the close of the last fiscal period and must be taxed to the stockholder at the lower rates prescribed for the year or period in which such surplus was accumulated.

The question of the construction of Section 31 (*b*) of the Revenue Act of 1917 is one of general application and does not in any way depend upon the peculiar facts of this case. The distributions here involved having been held by the Court below to be distributions of surplus, and therefore income, the only question now presented is, at what rate shall they be taxed? The answer to this question depends entirely upon whether by the phrase "most recently accumulated undivided profits or surplus" in Section 31 (*b*), to which all

distributions made by a corporation to its shareholders in the year 1917 must be allocated, Congress intended to include current earnings of the year in which the distribution was made, or whether, as held by the Circuit Court of Appeals, it intended to exclude such current earnings and referred only to the undivided profits or surplus account of the corporation as shown by the books at the close of the last fiscal period.

Much will of necessity be said concerning the accounting methods of corporations and of the practice of directors in declaring and paying dividends. In all this discussion it should be borne in mind that the tax involved is in no sense a tax on Phelps Dodge Corporation. It is a tax on the income of Dr. Douglas, and the accounting practices and bookkeeping methods of the corporation will be considered only because the claim is made that by reason of such methods and practices Dr. Douglas is entitled to be taxed at a lesser rate on certain distributions than is prescribed by law for income from other sources.

The principle underlying all income taxation is that the common burden shall be distributed among taxpayers according to their ability as reflected by their net income to bear it. The receipt of a given income calls for the payment of a certain tax. If a taxpayer receives income but claims that by the terms of the statute it is taxable at a lower rate than that prescribed for other income it is his duty to

point to some provision of the statute which clearly and unmistakably grants him such preferential treatment. In the argument which follows, this aspect of the case should not be forgotten. Section 31 (*b*) of the Revenue Act of 1917 does not deal with taxes imposed on corporations, nor does it lay down a rule of law about the declaration of dividends. It simply prescribes the rates at which a certain kind of income shall be taxed.

CONTENTIONS OF THE UNITED STATES

What then is the meaning of Section 31 (*b*)? It is the contention of the Government that—

(1) Well-settled principles of statutory construction require that the language of this section should not be extended by implication to grant this taxpayer a lower rate of tax.

(2) The circumstances attending the enactment of Section 31 (*b*) show clearly that it was the intention of Congress that distributions made by a corporation to its shareholders in the year 1917 should first be allocated to the earnings for that year and be taxed at 1917 rates and that only the excess of distributions over earnings should be allocated to the earnings of previous years and bear the lower rates of taxation.

(3) The literal construction of this section requires that dividends paid in 1917 should first be allocated to the earnings of the corporation for that year and be taxed at 1917 rates.

(4) The construction adopted by the Circuit Court of Appeals leads to such unjust and absurd results and produces such inequalities in taxation among individuals that it should not be upheld, since a more reasonable interpretation is present in the statute.

(5) The construction adopted by the Circuit Court of Appeals disregards the long-continued and practical construction of this section by Treasury officials, taxpayers, and corporations, including the taxpayer and corporation here involved.

Point I

Well-settled principles of statutory construction require that the language of Section 31 (b) should not be extended by implication to grant this taxpayer a lower rate of tax

Much was said by respondents in the Courts below about the principle of statutory construction that in case of doubt a taxing statute is to be construed most strongly against the Government and several decisions of this Court were cited in support thereof. It may be well at the outset of the argument to consider this contention in some detail in order to determine just what the so-called principle of strict construction means. It certainly does not mean that a taxing statute must always be construed so as to produce a smaller tax in a particular case. It is now well known that the construction of a taxing statute cuts both ways, and that a construction which results in a smaller tax

from one taxpayer will result in a larger tax from another. A construction which seems to one taxpayer to be strict against the Government will seem to another to be strict against him. It is a question of whose ox is gored.

Take for instance the effect of the very section now under consideration on the excess profits tax provisions of the Revenue Act of 1917. If as held by the Circuit Court of Appeals the phrase " most recently accumlated undivided profits or surplus " does not embrace current earnings for the year, but refers only to the undivided profits or surplus account, as it appeared on the books at the close of the preceding fiscal year, and if dividends paid in 1917 must be deemed to have been paid from such account, it is obvious that the invested capital of many corporations for 1917 would of necessity be reduced by the total amount of dividends paid during the year. Since, by the excess-profits tax provisions, the smaller the invested capital the higher the tax, a reduction in invested capital would be a very serious matter to a large number of corporations, and would result in their paying large additional excess-profits taxes. A construction which might seem strict against the Government to a taxpayer seeking to have the taxes on his distributions reduced would seem most strict against the taxpayer to such a corporation when the additional assesment comes through. No progress can therefore be made by appealing to this alleged rule in determining the effect to be given to Section

31 (*b*). The rule of construction, is not that in case of doubt a taxing statute should be construed in favor of a reduction on the tax to a particular taxpayer, but that the words of a taxing statute must not be extended to include any person or matter not strictly within the meaning of the words used, and if there is any doubt it will be resolved against any such extension. The principle has been stated by this Court in the case of *United States* v. *Merriam*, 263 U. S. 179, at pages 187–188, as follows:

> On behalf of the Government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer. *Gould* v. *Gould*, 245 U. S. 151, 153 (38 Sup. Ct. 53, 62 L. Ed. 211). The rule is stated by Lord Cairns in *Partington* v. *Attorney General*, L. R. 4 H. L. 100, 122:
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> " I am not at all sure that in a case of this kind—a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judi-

> cial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

It will be shown below that the construction here contended for is the literal construction of the language used in Section 31 (*b*).

There is, however, another aspect of the case which requires careful consideration. In the cases in which the so-called rule of strict construction against the Government of a taxing statute is laid down the Government was attempting to subject to the tax matters not clearly embraced within its terms. This is not the situation in the case at bar. Here the distributions have been held to be income and to come within the general provisions of the Revenue Act imposing a tax on incomes. Section I of the Revenue Act of 1916 imposes normal and additional taxes at specified rates upon the "net income received in the preceding calendar year from all sources by every individual, etc." Section 1 of the Revenue Act of 1917 (40 Stat. 300) imposes further normal taxes upon the net income of every individual, and Section 2 of that Act (40

Stat. 301) further additional or surtaxes. Section 2 (*a*) of the Revenue Act of 1916 (39 Stat. 756, 757), as amended by Section 1200 of the Revenue Act of 1917 (40 Stat. 329), defines net income as follows:

> (*a*) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trades, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

Had Section 31 (*b*) not been enacted these distributions would unquestionably be taxable at the rates prescribed by Section 1 of the Revenue Act of 1916 and Sections 1 and 2 of the Revenue Act of 1917. If now a claim is made that by reason of Section 31 (*b*) they are taxable at different and lower rates, it is clear that a case is not presented in which the Government is trying to subject to the tax something which otherwise would be exempt, but the case is one in which the taxpayer is asserting that income otherwise subject to certain rates of

tax is by that section to be taxed at lower rates. In other words, the instant case does not involve the imposition of the tax upon a given subject or the question of a statutory exception to the taxable class. It involves rather the *exemption* of matters otherwise subject to the tax at certain rates from such rates, and in such case the rule of law is not that the provisions of the statute under which such exemption is claimed must be construed strictly against the Government but that in case of doubt such provisions must be construed strictly against the taxpayer.

This distinction was pointed out by the Court in *Eidman* v. *Martinez*, 184 U. S. 578 at page 583, as follows:

> It is an old and familiar rule of the English Courts, applicable to all forms of taxation, and particularly special taxes, that the sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of *exception* confining the operation of duty (*Warrington* v. *Furbor*, 8 East, 242, 247; *Williams* v. *Sanger*, 10 East, 66, 69; *Denn ex dem. Manifold* v. *Diamond*, 4 Barn. & C. 243, 245; *Tomkins* v. *Ashby*, 6 Barn. & C. 541; *Doe ex dem. Scruton* v. *Smith*, 8 Bing. 146, 152; *Wroughton* v. *Turtle*, 11 Mees. & W. 561, 567; *Gurr* v. *Scudds*, 11 Exch. 190), though the rule regarding *exemptions* from general laws imposing taxes may be different. *Cooley, Taxn.* 146; *Re Enston*, 113

N. Y. 174, 177, *sub nom. People* v. *Sherwood*, 3 L. R. A. 464, 21 N. E. 87.

The case of exemptions claimed by a taxpayer has been specifically considered by this Court in other cases.

> Taxes being the sole means by which sovereignties can maintain their existence, any claim on the part of anyone to be exempt from the full payment of his share of taxes on any portion of his property must on that account be clearly defined and founded upon plain language. There must be no doubt or ambiguity in the language used upon which the claim to the exemption is founded. It has been said that a well-founded doubt is fatal to the claim; no implication will be indulged in for the purpose of construing the language used as giving the claim for exemption, where such claim is not founded upon the plain and clearly expressed intention of the taxing power.
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> *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, at page 146.
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> But if there were a doubt as to the meaning of the statute that doubt should be resolved in favor of the government. Whoever claims a privilege from the Government should point to a statute which clearly indicates the purpose to grant the privilege.
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> *Cornell* v. *Coyne*, 192 U. S. 418, at page 431.

From these authorities it is plain that in a case like the present the so-called rule of strict con-

struction of a taxing statute against the Government has no application. Section 31 (*b*) is to be construed like any other statute; its language is not to be extended in order to bring within the taxable class matters not clearly covered or in order to grant to this taxpayer exemption from taxes otherwise clearly imposed upon him; and if there is any doubt as to whether he is entitled to such exemption that doubt is to be resolved in favor of the Government and not in favor of the taxpayer.

Point II

The circumstances attending the enactment of Section 31 (b) of the Revenue Act of 1917 show clearly that it was the intention of Congress that distributions made by corporations to their shareholders in the year 1917 should first be allocated to the earnings of the corporation for that year and should be taxed at 1917 rates, and that only the excess of distributions over earnings should be allocated to earnings accumulated in prior years and bear lower rates of taxation

The Revenue Act of 1917 was passed almost six months after the United States had entered the World War, at a time when large profits were being made by a great many corporations and when additional revenue was urgently needed by the Government to defray the heavy expenditures incurred and to be incurred in the prosecution of the war. Congress in this Act imposed far higher taxes upon income than had been imposed by prior Revenue Acts and in addition levied heavy excess-profits taxes on individuals and corporations. These heavy taxes applied to all forms of income, earned

and unearned, and imposed burdens upon the citizen theretofore unheard of. Under the Income Tax Act passed on October 3, 1913, ch. 16, 38 Stat. 114, all dividends distributed after March 1, 1913, were taxable, whether the profits out of which such dividends were declared were accumulated before or after that date. *Lynch* v. *Hornby,* 247 U. S. 339; *Peabody* v. *Eisner,* 247 U. S. 347. The Revenue Act of September 8, 1916, ch. 463, 39 Stat. 756, permitted the declaration of dividends out of surplus accumulated prior to March 1, 1913, tax free, even though profits earned subsequent to March 1, 1913, remained undistributed. With this exception dividends under both Acts, although exempt from normal tax upon the theory that the normal tax had been paid by the corporation, bore the same rate of surtax as other income; and in the House bill the provisions of the Revenue Act of 1916 were left unchanged. When the bill reached the Senate, however, the question of dividends received further consideration.

A stockholder in a corporation having on hand a large amount of undistributed earnings of prior years, but which owing to the disturbed condition of business brought about by the war was unable to operate at a profit, presented a case of peculiar difficulty and hardship. In order to pay dividends in 1917 the corporation would be forced to draw upon its surplus of prior years, and it was clear that if such dividends were to be taxed at the high 1917 rates distributions would be greatly curtailed.

This would be a hardship on the stockholder and a loss to the Treasury; and even if such distributions could be compelled, it was not considered fair that they should be taxed at 1917 rates when it was clear that the only earnings which could be distributed were the earnings of prior years accumulated when the tax rate was low. At the same time, the necessities of the Treasury and the large earnings that were being made by corporations engaged in some form of war activity during 1917 rendered it imperative that corporations should not have the right to decide from what earnings their cash distributions were coming. The natural desire on the part of stockholders to escape the heavy tax rates for the year 1917 would have led directors to declare their distributions from surplus accumulated prior to March 1, 1913, or from surplus accumulated when the tax rate was low. The result was the rules of allocation laid down in Section 31 (*b*).

It is obvious that Section 31 (*b*) exempts from taxation only one form of income, namely, a distribution out of earnings and profits accrued prior to March 1, 1913, absolutely, if the distributions were made prior to August 6, 1917, and if made subsequent to that date, only if all earnings and profits accrued subsequent to March 1, 1913, have first been distributed.

It is also clear that by using the word "deemed," the statute laid down a rule of law as to the rate at which distributions should be taxed, which could

not be changed by a declaration of the Board of Directors as to the surplus from which the distribution was supposed to have been made. This was held by the court below and there can be no doubt of the correctness of this ruling.

The word " deemed " has been held to be synonymous with " adjudged," " considered," " regarded," and " determined " (*Cardinel* v. *Smith,* Fed. Cas. No. 2395; *Leonard* v. *Grant,* 5 Fed. 11, 16; *Harder* v. *Irwin,* 285 Fed. 402, 406), and if in Section 31 (*b*) any of these synonyms are substituted it becomes perfectly plain that what Congress intended by the language of that section is that any distribution made by a corporation to its stockholders in the year 1917 should be treated for the purpose of computing the tax thereon as if it had been declared by the directors from the most recently accumulated undivided profits or surplus, and nothing in the resolution declaring the dividend should in any way change the rate at which it should be taxed.

Bearing in mind the fact that this section lays down a rule of law as to the rates at which distributions made in 1917 should be taxed, the question arises, what did Congress mean by the phrase " the most recently accumulated undivided profits or surplus "? Did it intend that this phrase should include earnings for the year 1917 on hand at the time of the distribution, or did it intend that it should refer only to the undivided profits or surplus account of the corporation as it appeared on

the books at the close of the last fiscal period, and that notwithstanding large 1917 earnings, dividends should be allocated to such undivided profits or surplus account and bear the lower rates of taxation prescribed for some prior year?

The Court below, in holding that only the surplus or undivided-profits account of the corporation as it appeared on the books at the close of the last fiscal period was intended, relies most strongly on what it calls the legislative history of Section 31 (*b*). The bill as it originally passed the Senate contained the following provisions: (Cong. Rec., 65th Cong., 1st Sess., Vol. 55, Part 7, pp. 6869, 6870, 6877, 6886.)

> Provided, further, That any distribution made to the shareholders of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the net income of the years in which such distribution is made or, if such income is insufficient, from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the shareholder for the respective years in which earned by the corporation, joint stock company, or association, or insurance company, and shall be taxed to the shareholder at the rate prescribed by law for such year.

The bill went to conference and as reported by the Conference Committee contained Section 31 (*b*) in its present form. (Cong. Rec., 65th Cong.,

1st Sess., Vol. 55, Part 8, pp. 7613–7614.) The Court argues that the elimination of the provision allocating dividends to the net income of the corporation for the year in which earned and leaving the allocation only to the most recently accumulated undivided profits or surplus shows an intention on the part of the Conference Committee not to permit the allocation to current earnings but to confine it entirely to the undivided profits or surplus account of the corporation at the close of the last fiscal period.

This interpretation of this change is not sound. The utmost diligence on the part of counsel has failed to discover any statement in Congress which in any way explains this change or gives any reason therefor. This silence is in reality of more significance than the change itself. Under the Act of October 3, 1913, dividends were subject to taxation at the rates prescribed for the year in which they were paid. The same was true under the Revenue Act of 1916, the only exception being that dividends might be declared tax free from surplus existing on March 1, 1913. Under all subsequent revenue Acts dividends are taxed at the rates prescribed for the year in which paid.

The Revenue Act of 1917 in the form in which it passed the House provided for taxation of dividends at 1917 rates except dividends declared out of surplus accumulated prior to March 1, 1913, of which provision only a comparatively small number of corporations could take advantage. Yet the argu-

ment of the Court below is that a mere change in phraseology in a section of the bill is a sufficient basis for holding that Congress intended to introduce a far reaching change in income taxation; that with the exigencies of the War requiring the tapping of every available source of revenue Congress intended to forego taxes at 1917 rates on war profits coming to individuals in the form of dividends and seriously to reduce the amount of revenue to be derived from the bill below the estimates therefor, all without one word of explanation or comment. Surely, if it had been the purpose of this change in wording so to change the intention expressed in the Senate draft of the bill, some explanation of the reasons for the change would have been forthcoming. Some protest would certainly have been made against what must have seemed to many Members of Congress an unjust and unwarranted discrimination in favor of war profits and against income derived from permanent investments and personal efforts.

There is, however, a much more reasonable explanation of this change. It must be remembered that this is not a case of a change in a statutory provision which had been in force for a number of years and which had received both executive and judicial construction. In such a case the argument is undoubtedly sound that a change in the language indicates an intent to change the law. We are dealing here with an entirely new provision, which had not appeared in any prior Revenue Act,

and a change in the phraseology in the progress of the bill though Congress may mean no more than an improvement in draftsmanship, an expression of the same intention in more appropriate language.

An illustration of this may be found in the changes in the language of this very section in regard to taxing dividends from surplus accumulated in prior years at the rates prescribed by law for the years in which such surplus was accumulated. In the Senate bill this provision read:

> * * * shall constitute a part of the annual income of the shareholder for the respective years in which earned by the corporation * * * and shall be taxed to the shareholder at the rate prescribed by law for such year. (See page 26 this brief.)

In Section 31 (*b*) as finally enacted this provision reads:

> * * * shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation * * *.

In both cases the intention is the same, namely, that a stockholder receiving a distribution out of surplus accumulated when the tax rate was low should be taxed upon such distribution at the low rate. The language of Section 31 (*b*) used to express this intention is radically different from the

language used in the Senate draft of the bill, and the reason for this change is obvious. The Senate draft, if enacted into law, would have produced endless confusion in determining how income received in 1917 could possibly constitute a part of the income of the distributee for a prior year when he did not receive and had no right to receive the same. In the final form of the bill Congress, without in the least changing its intention, changed its language to express this intention more aptly.

In the same way Congress in eliminating the words " net income " did not change its intention of requiring dividends paid in any tax year to be allocated first to the current earnings of the year in which paid. It merely expressed that intention more appropriately. The phrase " net income " would not have brought about the result which both respondents and the learned Court below concede was intended by the Senate draft. Net income is not synonymous with current earnings. It is a purely statutory conception. Net income, under the statute, is to be determined by taking from gross income as defined certain specified deductions. The result is purely artificial and may or may not have any definite relation to actual income, earnings, or profits. Net income having been given this technical meaning in the act would have carried that meaning into Section 31 (*b*), and the use of this phrase might have excluded from the operation of the section large amounts of actual earnings and included therein legitimate expenses not allow-

able as deductions. It would also have given rise to most difficult questions in determining whether the "net income" was sufficient to cover the distributions made. For instance, would the "net income" to which dividends must be allocated be the total "net income" of the corporation, including the very substantial part which might be required to pay the excess-profits tax, or would it be only what was left after the excess-profits tax had been credited?

From the above it can readily be seen that if enacted in the form of the Senate bill the section would not have allocated dividends to current earnings but to an artificial "net income," entirely different from those earnings. The law in that form would certainly have been ambiguous and would have been a fruitful source of controversy and litigation. It doubtless would have been better if Congress in changing its language had used the phrase "most recently accumulated earnings and profits" which would have expressed its intention precisely. On the other hand, as will be shown below, the phrase "most recently accumulated undivided profits or surplus" literally construed does include current earnings and profits as well as surplus accumulated in the past and therefore aptly expresses the meaning attempted to be expressed by the Senate bill. Without doubt the changes made in the Conference Committee were designed not to change the meaning expressed in the Senate bill, but to

express that intention in clearer and more precise language.

Certainly there is nothing in any of the drafts of the bill in either the House or in the Senate which would lend color to the argument that Congress ever showed the slightest intention of exempting from taxation at 1917 rates dividends paid by a corporation which was making profits in that year sufficient to pay them. The bill as it passed the House made dividends paid in 1917 taxable at 1917 rates, unless specifically declared out of earnings or profits accrued prior to March 1, 1913. This made all dividends subject to the high surtax rates, except dividends received from the relatively few corporations which still had a surplus accumulated prior to March 1, 1913. The Senate went further and made a concession to the equity of stockholders in corporations, making no profits in the year 1917 on account of the general disturbance of business due to the war, which in paying dividends were obliged to draw upon their surplus of prior years.

But neither House nor Senate, nor any committee of either, ever exhibited the intention of allowing dividends paid in the year 1917 by corporations which had earnings for that year sufficient to pay them to be taxed at the lower rates prescribed for the year 1916 or former years. Surely if there had been an intention of changing the rule adopted in all other acts that dividends shall bear the tax rate of the year in which paid,

and of giving them favored treatment over income derived from interest, rents, profits on sales, and compensation for personal service, some explanation and justification of such an extraordinary change and discrimination would be found in the Congressional Record.

The Court below in support of its construction of Section 31 (*b*) goes into a very elaborate discussion of the dividend provisions of the Revenue Act of 1918 (Act of February 24, 1919, ch. 18, 40 Stat. 1057, 1059). It is a short and complete answer to the argument of the Court on this point to say that the Court entirely misconceived the nature of these provisions. The Revenue Act of 1918 taxed all cash dividends at the rates prescribed by law for the year in which paid irrespective of when the profits from which the same were paid had been accumulated. The only exception to this rule was that surplus accumulated prior to March 1, 1913, might be distributed free from tax after all earnings and profits accumulated since that date had been distributed. The rules of allocation of cash dividends laid down in Section 31 (*b*) of the Revenue Act of 1917 were therefore repealed by the provisions of the Revenue Act of 1918. By Section 201 (*d*) of that Act, 40 Stat. 1059, they were retained as a matter of equity in regard to stock dividends declared or paid between January 1 and November 1, 1918, before the Act was passed. This provision became unconstitutional by the decision of this Court in *Eisner* v. *Macomber,* 252 U. S. 189, and is of comparatively

slight importance. In particular, Section 201 (*e*) of the Revenue Act of 1918, and Section 201 (*f*) of the Revenue Act of 1921 (Act of November 23, 1921, ch. 136, 42 Stat. 227), providing that any distributions made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years, has been misunderstood by the Court. This is in no sense a provision in regard to the taxation of dividends.

Dividends paid in the first sixty days of any taxable year bear the rate of tax prescribed for that year. (*Adams* v. *United States,* decided by the Court of Claims Feb. 9, 1925; unreported to date.) This provision relates purely to the invested capital and excess profits tax of the corporation and provides that the invested capital of a corporation shall be reduced by the amount of distributions made during the first sixty days of any taxable year. In so far as this section has any relevancy to the case at bar it shows that notwithstanding the elaborate arguments of respondents and the Court below that dividends can not be declared out of current earnings, Congress in enacting the Revenue Acts of 1918 and 1921 recognized that they could be, and provided that such declarations should not reduce invested capital. It also shows that Congress used the word " accumulated " to designate earnings on hand and undistributed during the current year, a fact which the learned court apparently overlooks

in stressing so strongly the use of the word " accumulated " in the section under consideration.

Since, however, the Court below has relied so strongly on the provisions of the Revenue Act of 1918 (Act of February 24, 1919, ch. 18, 40 Stat. 1057), in order to discover the intention of Congress in enacting Section 31 (*b*) of the Revenue Act of 1917, it may not be amiss to consider a statement of the Committee on Ways and Means of the House of Representatives on September 3, 1918, reporting the bill which subsequently became the Revenue Act of 1918. It must be remembered that the Revenue Act of 1917 was passed at the first session of the Sixty-fifth Congress and the Revenue Act of 1918 at the second session of the same Congress. A report by the House Committee in charge of the new revenue bill made within a year of the passage of the former act, explaining such former act and the changes which it was desired to make in the new act, are certainly material to a consideration of the intention of Congress in the former act. The following statement in regard to the dividend provisions of the bill which subsequently became the Revenue Act of 1918 is to be found in the Congressional Record:

> The dividend provision makes any distribution made by a corporation out of its earnings or profits accrued since February 28, 1913, and payable to its shareholders or members, whether in cash or in other property or in stock of the corporation, subject to tax

in the hands of the shareholder, the same as under the present law. It also provides that any distribution made in 1918 or subsequent years shall be deemed to have been made from earnings or profits accrued since February 28, 1913. *The present law provides that dividends distributed to the stockholder shall be taxable to the individual at the income-tax rates in effect in the year in which the dividend is received, unless the corporation distributes more than its earnings for the taxable year, in which case the additional amounts so distributed are taxable in the hands of the individual at the rates in effect during the year in which the corporation earned the same.* Under the proposed bill all distribution of earnings accrued since February 28, 1913, will be taxable in the hands of the stockholder according to the rates in effect during the year in which the dividend is received. The proposed bill, like the present law, provides that earnings or profits accrued prior to March 1, 1913, may be distributed in stock dividends or otherwise exempt from tax after the earnings and profits accrued since February 28, 1913, have been distributed.

House Report No. 767, 65th Cong. 2d Session, dated Sept. 3, 1918, pp. 3–4. (Doc. Series 7308.) (Italics ours.)

Nothing could show more clearly the intention of the Committee of the same Congress which enacted the Revenue Act of 1917 as to the effect of Section 31 (*b*). In this statement the Committee

gives to this section the very construction for which the Government contends.

From the above it will be seen that the circumstances surrounding the enactment of this section show clearly that by the phrase "most recently accumulated undivided profits or surplus" to which all dividends are to be allocated Congress did not intend to exclude current earnings for the year but intended to include the same and to provide that all distributions made in the year 1917 should first be allocated to the earnings of that year, and that only when these were exhausted should resort be had to surplus accumulated in prior years.

Point III

The exact and literal meaning of the phrase "most recently accumulated undivided profits or surplus" embraces current earnings. To construe this phrase as excluding current earnings and referring only to the "undivided profits or surplus account" of the corporation as shown at the close of the last fiscal period is to extend the terms of the statute and to read into it matter which Congress did not see fit to insert

In order to determine the meaning of the phrase "most recently accumulated undivided profits or surplus" resort should be had in the first instance to the meaning given to these terms in common speech.

Respondents argue that the terms "accumulated undivided profits or surplus" have a well settled signification in business accounting and mean the "undivided profits or surplus account" as it existed at the close of the last fiscal period. In

this technical sense, it is urged, no profits become "undivided profits" or "surplus" until they have been set aside at the end of an accounting period and allocated to certain accounts known as the "undivided profits" or "surplus" accounts. The word "surplus" has, however, a well established meaning far broader than this alleged technical meaning of "surplus account," namely, the excess of assets over liabilities and capital stock, and this broader meaning is found in technical works on accounting and has repeatedly been adopted by the Courts. "Surplus" is defined by Webster's New International Dictionary, "* * * as distinguished from the capital stock of a corporation, the excess of net assets over the total value of its shares."

In *Kester, Accounting Theory and Practice,* at page 407, we find:

> Under the corporate form of organization, "surplus" in its broadest sense represents the difference between the net worth of the business and the capital stock issued and outstanding.

In *A. Lowes Dickinson "Accounting Practice and Procedure,"* at page 63, it is stated:

> The term "surplus," which is in quite common use, is better confined to the surplus of assets over liabilities, made up * * * of appropriations for various purposes as well as of the balance of undistributed profit and loss.

Leo Greendlinger in "*Financial and Business Statements*" says:

> By the term surplus is meant the intrinsic value of all the assets of a firm over and above its liabilities and outstanding capital (page 195).

In the *Year Book for 1911* of the American Association of Public Accountants it is said (p. 124):

> Surplus: (*a*) In the restricted sense it means accumulated undivided profits.
>
> (*b*) When used in the ordinary sense in a financial statement, it means excess of assets over liabilities and capital. In this sense surplus may include gains arising from acquisition of assets not derived from the ordinary operation of the business. If the excess of assets equals the capital there is no surplus, the capital just balancing the excess or net worth of the business.

In "*Accountants' Reports,*" by W. H. Bell, it is said, at page 60:

> *Surplus:* While the word "surplus" literally denotes the excess of assets over liabilities and original capital, when employed without explanation of its composition, it is usually intended to, and in fact should mean earned surplus, as distinguished from capital or special surplus.

And similar definitions have been adopted by the Courts: Thus in *Fidelity Trust Co., etc.,* v. *The*

Board of Equalization, etc, 77 N. J. L. 128, at page 130:

> In order to ascertain the capital and surplus it is necessary to find the true value of the gross assets. From this must be deducted debts and liabilities, the remainder will be the value of the capital and surplus, if any.

In *People ex rel., etc.,* v. *The Board of Commissioners, etc.,* 76 N. Y. 64, it is said at page 74:

> " Surplus " earnings is an amount owned by the company over and above the capital and actual liabilities, * * *.

In *Leather Mfrs. Nat. Bank* v. *Treat,* 116 Fed. 774 (Aff. 128 Fed. 262), at page 775, Lacombe, C. J., defined surplus—

> in its natural and ordinary sense as including the entire overplus of assets over liabilities.

In *Anderson* v. *Farmer's Loan & Trust Co.,* 241 Fed. 322, at pp. 326–327, this Court said:

> * * * the words " capital, surplus, and undivided profits " relate to no particular kind of property but are expressions describing the amount of the residue of the assets after the liabilities have been deducted.

This last definition of " surplus " is adopted by the Court below (p. 104).

Thus even among accountants the term " surplus " is not limited to " surplus accounts " in the sense used by the court below, but is synonymous

with any excess of net assets over capital stock, whether such excess is made up of undistributed current earnings or of earnings of preceding fiscal periods, which have been placed in the so-called "surplus" account. Even if modified by the word "accumulated," the word "surplus" has no different signification, the word "accumulated" meaning simply "heaped up," "collected," or "brought together," "amassed," and it was unmistakably used by Congress in this sense in Section 201 (*e*) of the Revenue Act of 1918 and Section 201 (*f*) of the Revenue Act of 1921.

Congress, however, did not limit itself to the phrase "surplus" or "accumulated surplus," but in order to reach distributions from earnings on hand it used the words "accumulated undivided profits or surplus." If on a narrow construction of the term "surplus" it might be contended that it does not include the earnings for the current fiscal period, this construction is inapplicable to the term "profits" or "accumulated undivided profits." The word "profits" is one in common use, unambiguous, and primarily means "pecuniary gain" in any business, transactions, or investments, or excess "of sale price over cost."

The learned Court below does not apparently differ with this definition of "undivided profits." The Court says (p. 104):

> It (the term "undivided profits") means such profits as exist and have or have not been ascertained, but, in any event, have not

> been distributed or otherwise used, and is distinguishable from current earnings or profits.

The last statement, that the term is distinguishable from current profits, is added without explanation and is in reality inconsistent with the preceding statement, namely, that undivided profits are "such profits as exist and have or have not been ascertained, but, in any event, have not been distributed." A better definition of current earnings can not be conceived.

In Section 207 of the 1917 Act Congress in defining "invested capital" again used the phrase "undivided profits," and its use in this connection is strong evidence of the manner in which it was used in Section 31 (*b*). Section 207 specifies what assets may be recognized in calculating the invested capital of a partnership or corporation for excess profits tax purposes, and provides that it shall include "(3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year," 40 Stat. 306. As so used, "undivided profits" can mean nothing but current earnings of the taxable year. This phrase is repeated in Section 326 of the Revenue Act of 1918, 40 Stat. 1092, and again in Section 326 of the Revenue Act of 1921, 42 Stat. 274. By qualifying the term "undivided profits" in this section with the clause "exclusive of undivided profits earned during the taxable year" Congress plainly disclosed its intent

to use the term "undivided profits" so as to include therein the current earnings for the taxable year. If "undivided profits" referred only to those amounts which had been set over into a "surplus account" or an "undivided-profits account" at the close of any particular fiscal year, then the modifying and qualifying clause contained in Section 207 would have been unnecessary.

The foregoing provision makes it clear that Congress regarded current earnings as "surplus or undivided profits," and that in using such term Congress had not in mind any segregation of profits of previous years to the exclusion of current earnings, but used these words in their common signification of any excess of assets over liabilities including capital stock, and of profits on hand and undistributed, no matter when acquired. "A word or phrase repeated in a statute will bear the same meaning throughout the statute, unless a different intention appears." *Lewis Sutherland's Statutory Construction*, Vol. II, 2nd Ed., page 758. No different intention appearing, the phrase "undivided profits" must be taken to mean the same in Section 1211 as it does in Section 207 of the Act of October 3, 1917, and to include earnings and profits for the current fiscal period.

Literally therefore surplus and undivided profits embrace current earnings. Such earnings are part of the surplus on hand at any time, and since they have been most recently acquired are the most recently accumulated surplus. In order to

exclude them it is necessary to read "surplus," not in its ordinary sense of excess of assets over liabilities and capital stock, but in the very special sense of "surplus *account.*" This involves an extension of the terms of the statute. In the same way in order to exclude earnings from "undivided profits" it is necessary to construe this term not as "profits which exist and have or have not been ascertained, but in any event have not been distributed," but as such profits as have been ascertained by a balancing of the books and the closing of the same into an undivided profits account.

The Court below relies upon the use of the words "earnings and profits" six times in Section 31 (*a*) and (*b*) and the use of the phrase "undivided profits or surplus" when the tax rate is prescribed. It holds that the words "earnings and profits" includes current earnings and that had Congress intended to allocate dividends first to current earnings it would have used the phrase "most recently accumulated earnings and profits." In other words, the Court holds that Congress intended to contrast undivided profits or surplus with earnings and profits, and by making this distinction to exclude current earnings as a fund to which dividends should be allocated.

To demonstrate that no such distinction was intended it is only necessary to refer to the following provisions of Section 31 (*b*):

> * * * Nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made.

Here Congress used the words "earnings and profits" instead of "undivided profits or surplus," but it is clear that it did not use them as contrasted with "undivided profits or surplus," but only in a more limited sense, exactly analogous to the term "undivided profits." The absolute rule of law which is here laid down prohibits the distribution of earnings and profits accrued prior to March 1, 1913, until after there has been distribution of all earnings and profits accrued since.

This is a positive prohibition which includes not only earnings set over into a surplus account or an undivided profits account, but also earnings and profits accrued during the current fiscal period. No narrower construction of these words is possible nor is a narrower construction claimed by the Court below. Current earnings must be distributed before there can be a distribution of earnings and profits accumulated prior to March 1, 1913. Consequently if all the surplus accumulated between March 1, 1913, and the close of the last fiscal period has been distributed, but the corporation has on

hand current earnings it can not distribute its March 1, 1913, surplus tax free until it has distributed its current earnings. But if it distributes its current earnings at what rate shall they be taxed? To say that they are tax free is directly to disobey the provisions of the statute that no tax free distributions shall be made under such circumstances. On the other hand, to say that such distributions are taxable at 1917 rates is to admit that under certain circumstances current earnings may be the most recently accumulated surplus or undivided profits.

The contention that the term "accumulated undivided profits or surplus" was used to the exclusion of current earnings and profits, thus leads to a manifest absurdity which will not permit of rational solution and which it can not be supposed that Congress intended. It is only when "undivided profits or surplus" is read as a broader term including "earnings and profits" (and current earnings and profits as well) that the section becomes clear and consistent. It then lays down a perfectly sensible rule, namely, that a corporation must first distribute its current earnings, which are taxable at the rates prescribed for the year in which the distribution is made; it may then distribute the earnings for the last fiscal period and so on back to March 1, 1913, each distribution being taxable at the rate in force at the time the earnings distributed accrued. When all earnings accrued since March 1, 1913, have been distributed,

then tax-free distributions may be made. If the term "accumulated undivided profits or surplus" is held to include "earnings and profits," the statute becomes clear and consistent and the obvious intention of Congress will be effected. Dividends will be "deemed" to have been paid from the most recently acquired earnings lawfully applicable thereto—the literal meaning of the words expressing the Congressional intent.

Point IV

The construction of Section 31 (b) adopted by the learned Court below leads to absurd results and produces inequalities and injustices among taxpayers. It should not be upheld since another and more reasonable interpretation is present in its terms

It is a cardinal rule of construction frequently recognized by the Court that statutes are to be construed so that unjust and absurd results will be avoided.

> Nothing is better settled than that statutes should receive a sensible construction, such as will effectuate the legislative intention, and, if possible, so as to avoid an unjust or an absurd conclusion.
>
> *Lau Ow Bew* v. *United States,* 144 U. S. 47 at p. 59.

> We are, therefore, bound to give heed to the rule that where a particular construction of a statute will occasion great inconvenience or produce inequalities and injustice, that view is to be avoided if another and

more reasonable interpretation is present in the statute.

Knowlton v. *Moore,* 178 U. S. 41 at p. 77.

In the argument under the preceding point some of the absurd results of the construction of Section 31 (*b*) adopted by the Court below have been touched on. To hold that the term " most recently accumulated undivided profits or surplus " is to be given a special and a technical meaning and that it includes only amounts which have been set over at the end of a fiscal period into a surplus account or an undivided profits account leads to discriminations and inequalities, which Congress must have had in mind and which it can not be presumed to have intended. It is well recognized that some corporations carry over into their surplus account at the end of each month their earnings for the month; with others the practice is to carry the amounts over at the end of each quarter; still others close their books semiannually. If such corporations should have made distributions in September and December, 1917, as did the Phelps Dodge Corporation, then there would have been included in such distributions earnings accrued in 1917. The dividends, to the extent that they represented surplus accumulated in 1917, would have been taxable at 1917 rates. Did Congress intend that the rate at which dividends are taxed should depend upon the way that the corporations, from which dividends are received, keep their books? If it did, it certainly made the rate of taxation of

individuals and the amount of revenue collected depend upon an arbitrary and very trivial circumstance.

Suppose four corporations engaged in the same line of business, earning exactly the same amounts and making the same distributions to their stockholders in 1917. The first closes its books monthly; the second, quarterly; the third, semiannually; the fourth, annually. Although the actual facts are the same in each case, yet under the construction adopted by the Court below the rates at which the stockholders are taxed will vary enormously, depending upon a circumstance over which they have no control, and which furnishes no ground for making any distinction.

The argument of the Court below that in allocating dividends to the "surplus or undivided profits accounts" Congress intended that such account should be determined exclusively on an annual basis will not hold. The statute says nothing about how the surplus and undivided profits shall be determined nor is there authority for reading such a proviso into it. The fiscal period of a business is by no means always the year. It is often much shorter, depending upon the needs of the business. (See *Kester, Accounting Theory and Practise,* 2nd Ed., Vol. 1, page 48.) There is no reason to suppose that because the Act contemplates an annual system of taxation it must have contemplated an annual closing of books. Furthermore, even if we imagine that it did, the

inequalities pointed out would prevail in the case of corporations whose fiscal years closed in the earlier months of the year. In such cases with the same earnings and the same distributions stockholders of corporations, which ended their fiscal year in April, July, or October, would be taxed at far higher rates than stockholders in corporations, the fiscal year of which is the same as the calendar year.

It is not an answer to this argument to say that in the latter case the tax would only be postponed and that if the Revenue Act of 1917 had continued in force distributions in 1918 would have been taxed at 1917 rates. The fact remains that in 1917 stockholders in different corporations making the same earnings and paying the same amount in dividends would be taxed at widely different rates, depending upon the bookkeeping methods of the corporation. This is a result which Congress could not have intended. As is well said by the Court below in regard to the other aspect of this case (p. 97):

> * * * but it is well at the outset to realize that, in this case, the rights of the parties can neither be established nor impaired by the bookkeeping methods employed or by the names given to the various items.

Or to adopt the language of the learned District Court (p. 20):

> It seems to me that the Congressional intent is clear. Distributions to shareholders

> are to be regarded as made from current earnings and the most recently accumulated surplus. Congress, in my judgment, did not intend to lay down a narrow rule to be whittled away by technical definitions of the terms surplus, undivided profits, dividends, and distributions. Nor did it intend to recite a mere prima facie rule which could be arbitrarily set aside by the form of the bookkeeping entries. It is to be assumed that Congress desired that, so far as possible, the tax should be regulated by the substance of things and not their form, and that taxation should not fall more lightly upon one man than upon another because of ingenuity in bookkeeping methods.

For other cases holding that taxation must be based upon the facts and not upon bookkeeping methods, see:

Southern Pacific Co. v. *Lowe*, 247 U. S. 330.

Leather M'f'rs. Nat. Bank v. *Treat*, 128 Fed. 262, at page 265.

Baldwin Locomotive Works v. *McCoach*, 215 Fed. 967 (aff. 221 Fed. 59).

Industrial Trust Co. v. *Walsh*, 222 Fed. 437.

Forty Fort Coal Co. v. *Kirkendall*, 233 Fed. 704.

Anderson v. *Farmers' Loan & Trust Co.*, 241 Fed. 322, 328.

If it be supposed, as was the case with many corporations, that on December 31, 1916, the corpora-

tion had no surplus, and if it be supposed that as a result of the war the corporation made large profits in 1917, which it distributed to its stockholders in that year, under the construction of this section by the Court below would such a distribution be tax free? If not, at what rate would it be taxed? If the answer is at 1917 rates, is it conceivable that Congress intended that the tax rates on individuals should vary according to the previous financial condition of the corporation? Suppose—again a very common case—that the corporation was not organized until 1917 and was created for the sole purpose of engaging in some form of profitable war work; suppose that it made large profits in 1917, which it distributed to its stockholders in that year. According to the Court below, would these distributions be tax free? If not, would they be taxed at 1917 rates?

If the answer to these questions is that the distribution would be tax free, the result is so absurd and so contrary to the manifest intention of Congress as disclosed by the circumstances attending the enactment of the statute that a construction requiring such an answer is untenable on its face.

The Court below did not give a direct answer to the case just put. The reason is that it can not be answered. The suggestion that the tax is only postponed is surely not an answer, since by hypothesis the earnings for the year are distributed in 1917, and consequently no distribution of the same in 1918 could possibly be made. If such dis-

tribution could be made tax free a corporation in the situation outlined above could, by continuing to make annual distribution of its earnings, effectually prevent the imposition of a tax upon its stockholders, a result which could not have been in contemplation of Congress.

If, on the other hand, the answer to the above questions is that the distributions should be taxed at 1917 rates, then it is apparent that the words "most recently accumulated undivided profits or surplus" of a corporation do or may include current earnings and that the construction of this phrase by the Court below is erroneous.

It is likewise fundamental that a statute is to be interpreted according to the intention of the legislature apparent on its face. *Wilkinson* v. *Leland*, 2 Pet. 627. The intention apparent on the face of this act is that distributions should first be made out of 1917 earnings so far as they will go, and be taxable at 1917 rates, no matter when, or how often, the books of the corporation are closed. When these are exhausted, distribution may be made from 1916 surplus, and so on. It certainly was not the intention of Congress that all distribution made in 1917 should be taxed at 1916 rates or lower, if perchance the corporation had a surplus on its books at the close of its last fiscal period; that, with the exigencies of the war requiring that every available source of revenue should be drawn upon, distribution by such corporations should bear the comparatively low rates prescribed by the 1916 or some earlier

Act; that the man who earned his income in that year should pay a normal tax of 4 per cent and surtaxes as high as 63 per cent, whereas the man who derived his income from dividends should pay surtaxes of only 13 per cent at the highest. The Court is bound to give effect to the manifest intention of Congress if it is possible so to do. Here the language of the section if construed in its ordinary and literal sense will effectuate this intention. To go beyond leads only to confusion.

Point V

The construction of Section 31 (b) adopted by the learned Court below disregards the long-continued construction of this section by Treasury officials, taxpayers, and corporations alike

The Court below in its opinion discusses at length whether dividends are ordinarily paid out of current earnings and, concluding that they are not, advances this as a reason against the Government's construction of Section 31 (*b*). It is submitted that this question has no bearing whatever upon the construction of this section. As pointed out above, Section 31 (*b*) deals only with the question, at what rates shall certain forms of income received by an individual be taxed? Section 31 (*b*) is not directed to corporations or directors and does not attempt to prescribe how or in what manner dividends shall be declared or to what fund they shall be charged on the books. The section lays down the rule in regard to the taxation of individuals on certain kinds of

income received in the year 1917, and it is not perceived how the fact that some of the larger and wealthier corporations of the country can not ascertain their annual earnings until after the closing of their books at the end of a fiscal period has any bearing on how an individual receiving a distribution from such a corporation should be taxed.

If the question is at all relevant, it is submitted that to determine the construction of a section of a revenue act addressed to the country as a whole by the accounting practice of a comparatively small number of large corporations is to commit the fallacy of generalizing the particular. The vast majority of corporations know accurately at any time the amount of profits that have been made and govern their distributions accordingly. Even large corporations, like Phelps Dodge Corporation, can by trial balance, or other appropriate accounting method, determine the amount of their current earnings with a fair degree of accuracy. The close correspondence between earnings and distributions of Phelps Dodge Corporation in the years 1916 and 1917 shows that the directors were fully aware of the condition of the corporation during the year.

That there is no essential absurdity in speaking of a corporation distributing its earnings in a particular year appears from the fact that Congress in the 1918 and 1921 Acts expressly recognized that distributions could be and commonly were made out of current earnings.

Strong proof that the fair meaning of the words surplus or undivided profits in the statute includes current earnings is found in the fact that contemporaneous construction by taxpayers, corporations, and taxing officials agreed in so holding. If the construction of the Court below is correct, none of the regular dividends declared by Phelps-Dodge Corporation was taxable to the stockholders at 1917 rates. Yet Dr. Douglas returned all his regular dividends except the first (which the corporation had said was out of 1916 surplus) for taxation at 1917 rates (p. 75). The corporation itself ruled that all regular dividends except the first were out of 1917 earnings (p. 55).

Furthermore, in making up its excess profits tax return for 1917, the corporation did not reduce its invested capital (p. 35) by the amount of any of its dividends (including the depletion dividends), which it should have done had they all been paid out of 1916 surplus, since by Section 207 the invested capital must be averaged monthly and if the surplus going into invested capital is reduced for any reason, allowance must be made for such reduction in subsequent months.

The argument that Dr. Douglas and the corporation were coerced by the regulations of the Treasury Department into adopting this practice is not impressive. Paragraph 26 of Regulations 33, Revised, issued under the Revenue Act of 1917 (page 8), covering distributions from depletion reserves, clearly provided that no distribution would be

deemed to have been made from such a reserve except to the extent that it exceeded the surplus or undivided profits of the corporation at the time of such distribution. This paragraph was as precise as Article 107 hereinafter set forth, yet Dr. Douglas and Phelps-Dodge Corporation found no difficulty in attempting to assert freedom from taxation for the so-called depletion dividends notwithstanding the fact that the corporation had on hand surplus or undivided profits many times the amount of such dividends.

Article 107 of Regulations 33, Revised, pp. 61-62, was issued to give effect to Section 31 (*b*) of the Act of 1917, and is as follows:

> Any distribution made to shareholders in the year 1917 or subsequent years (except any distribution of dividends made prior to Aug. 6, 1917, out of earnings or profits accrued prior to Mar. 1, 1913) shall be deemed to have been made from the most recently accumulated undivided surplus or profits, and shall constitute income of the distributee for the year in which received, and shall be taxed to such distributee at the rates prescribed by law for the years in which such surplus or profits were earned by the distributing corporation.
>
> Thus, if a corporation distributed dividends in 1917 such dividends will be deemed to have been paid from the earnings of 1917, and the recipient, if an individual, will be liable to additional tax, if any, and if a corporation, to income tax, at the rates for the

> year 1917, unless it is shown to the satisfaction of the Commissioner of Internal Revenue that at the time such dividends were paid, the earnings up to that time were not sufficient to cover the distribution, in which case the excess over the earnings of the taxable year will be deemed to have been paid from the most recently accumulated surplus of prior years, and will be taxed at the rate or rates for the year or years in which earned.
>
> A corporation declaring and paying dividends out of a surplus or earnings accumulated over a period of years should make a record in its books of the amount of dividends paid out of each year's undistributed surplus or profits, and advise the stockholders accordingly, in order that the dividends received by them may be taxed at the respective rates prevailing during the years in which the surplus or profits so distributed were earned * * *.

This regulation has been followed by numerous Treasury decisions and rulings amplifying and explaining it, and never at any time has there been any ruling or practice of the Bureau of Internal Revenue inconsistent with this regulation. The contemporaneous and practical construction placed on the statute by the Bureau of Internal Revenue has been uniform and consistent, both in published decisions and in practice, and it is submitted that such construction "ought not to be overruled without cogent reasons."

United States v. *Moore,* 95 U. S. 760, at page 763.

The construction here contended for was sustained contemporaneously, but independently by the District Court (Judge Mack), in the case at bar (287 Fed. 919) and by the United States District Court for the Northern District of New York (Judge Cooper) in the case of *Harder* v. *Irwin,* 285 Fed. 402. It was also applied by the United States District Court for the Eastern District of Pennsylvania (Judge McKeehan) in the case of *Miller* v. *Lederer* (not yet reported, decided August 19, 1924).

It should be noted also that in the case at bar the issue here presented was not raised by the pleadings for at the time this action was brought it had apparently never occurred to respondents. Furthermore, there is no apparent reason for the rule. Why Congress, under the most urgent need of drawing upon all available sources of revenue in order to carry on the war should have decided to forego one of the largest and most fruitful sources; why it should have decided to discriminate so greatly in favor of income derived from dividends as opposed to income derived from interest, rents, or personal efforts; why it should have decided to tax at a lower rate, or to leave practically untaxed, the large war profits coming to individuals through dividends declared and paid in 1917, the Court below does not pretend to say. The suggestion of respondents that it was intended to leave these

profits free for investment in Liberty Bonds would apply equally to all other forms of income and certainly does not furnish a reason for the extraordinary tenderness which Congress is supposed to have shown to recipients of dividends. In default of such a reason Section 31 (*b*) should receive the sensible construction here contended for, the only construction which is consistent with all its provisions, with the obvious intention of Congress and with fairness to taxpayers of all kinds.

CONCLUSION

For the foregoing reasons the judgment of the Circuit Court of Appeals for the Second Circuit is erroneous and should be reversed and the judgment of the District Court reinstated.

Respectfully submitted.

JAMES M. BECK,
Solicitor General.
ALFRED A. WHEAT,
RICHARD S. HOLMES,
Special Assistants to the Attorney General.

MARCH, 1925.

O

In the Supreme Court of the United States

OCTOBER TERM, 1924

WILLIAM H. EDWARDS, COLLECTOR OF INTERNAL REVENUE, petitioner
v.
ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased

No. 524

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

I

Respondents' brief and the briefs submitted *amici curiae* exhibit a conception of the scope and effect of Section 31 (*b*) of the Revenue Act of 1917, in sharp contrast to the broad language used. On its face Section 31 (*b*) lays down a general rule of taxation of all distributions made by all corporations to their shareholders in the year 1917, and in treating of the subject of the Section uses the general language of Section 31 (*a*).

Section 31 (*a*) lays down a general definition of dividends as " any distribution made or ordered to

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be made by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders * * *."

Section 31 (*b*) lays down rules for the taxation of "Any distribution made to the shareholders * * * of a corporation * * * in the year nineteen hundred and seventeen, or subsequent tax years * * *."

The scope of Section 31 (*b*), therefore, is as broad as the scope of Section 31 (*a*), and it is clear from the language used that it was intended to apply to every distribution which was covered by the definition of dividends in Section 31 (*a*).

In the view of respondents, however, the primary purpose of Section 31 (*b*) is not to lay down a general rule in regard to the taxation of all dividends, but to apply only to distributions of a limited class of corporations, namely, those corporations which at the beginning of the year had an undivided profits or surplus account upon their books, leaving distributions by other corporations to be taxed at the rates prescribed for other income. (See respondent's brief, p. 52; brief of Messrs. Murray & Tweed, p. 18; brief of Mr. George E. Holmes, p. 12.)

This construction reads into the section a qualifying clause, and is inconsistent with the broad language used and with the relation of the section to Section 31 (*a*). It is negatived by the fact that every other part, except the last sentence, pur-

ports to lay down a general rule of taxation, and in the last sentence, in which an exception is admittedly made, specific words of exclusion are used.

If, as seems plain, Congress in Section 31 (*b*) intended to lay down a general rule for the taxation of all distributions, which could be subject to tax, it is to be presumed that the language used must be such as is applicable to all such distributions. Since distributions out of current earnings are lawful and customary, the only meaning of the words, "most recently accumulated undivided profits or surplus," which could apply to distributions by every corporation is one in which current earnings are embraced. By this construction the natural and literal meaning of these words is preserved and the section becomes one of universal application, which it unquestionably was intended to be.

II

The legislative history of Section 31 (*b*), set forth at such length in respondents' brief, confirms the assertion made in the main brief for petitioner that nothing can be found in the Congressional Record which in any way exhibits an intention on the part of the Conference Committee to change the meaning attempted to be expressed in the Senate draft of the bill. Attention is particularly called to the remarks of Senator Simmons, quoted at page 16 of respondents' brief. The Senate bill was adopted on September 10, 1917, and the Conference Committee's bill was reported to the Sen-

ate (Cong. Rec., vol. 55, part 8, p. 7606, 65th Cong., 1st sess.), and was passed by both Houses on October 2d, 1917. The remarks of Senator Simmons were made on the same day. If, as respondents say, these remarks are an accurate synopsis of the bill as passed by the Senate, and the bill was radically changed by the Conference Committee, why should the Senator have referred only to the discarded bill and failed to mention the change by the Conference Committee?

Much is made in all the briefs of the so-called proviso added by the Conference Committee to Section 31 (*b*), reading:

> * * * nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed * * * exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made.

It is argued that this proviso is surplusage under the Government's construction of Section 31 (*b*), and it is pointed out that it did not appear in the Senate drafts, the inference being that its insertion by the Conference Committee was due to the fact that the purpose attempted to be expressed by the Senate drafts had been changed. No such inference can be drawn. Under any construction of Section 31 (*b*) in its present form this proviso is necessary. Since the section provides for the taxation of distributions at the rates prescribed for

the *years* in which the surplus or profits from which they were made were accumulated, it might possibly have been held that earnings for the months of January and February, 1913, were to be taxed at 1913 rates. Under the original Senate theory that distributions were to constitute part of the income of the distributee for the year in which the surplus thereby distributed was earned by the corporation, it was unnecessary, since income received in January and February, 1913, could not constitutionally be taxed. When distributions were held to be income for the year in which *received,* the possibility of the taxation of earnings accrued prior to March 1, 1913, arose, and an express assertion of policy in regard to such earnings became necessary.

This assertion was made in the clause that earnings accrued prior to March 1, 1913, could be distributed exempt from the tax after the distribution of earnings and profits accrued since that date had been made. This removed any question which might have arisen from the fact that Section 31 (*a*) had been enacted in substantially the same form as the proviso in Section 2 of the Revenue Act of 1916, under which it had been held that earnings accrued prior to March 1, 1913, could be distributed tax free even though earnings accrued since that date remained undistributed. It also put at rest any possible doubt that the 1916 law had been changed and at the same time clarified the meaning of Section 31 (*b*). Respondents do not reconcile this clause with their construction of the words,

"most recently accumulated undivided profits or surplus." It is argued, however, in the brief submitted by Mr. George E. Holmes that the purpose of this clause was to allocate distributions to 1917 earnings and to tax them at 1917 rates after distribution had been made of 1916, 1915, 1914, December 31, 1913, surplus in the order named. But if it was intended to prescribe such an unnatural order of allocation, why was it not done in so many words? Why was it left to inference from a proviso to a proviso? This is an example of the fantastic readings of the section which must be indulged in, if the natural and literal meaning of "undivided profits or surplus" is departed from and a narrow construction of these terms is adopted.

III

The taxpayers base their construction of Section 31 (*b*) largely on the unsupported assertion that dividends are not commonly declared out of current earnings, but only out of the surplus on the books at the beginning of the fiscal period. (Respondent's brief, pages 28–38; Brief of Messrs. Murray and Tweed, pages 5–6.) It is assumed that directors do not and can not know what are the current earnings at any one time in the intermediate course of the year. The answer to this argument may be found in the financial pages of any newspaper or in the files of any recognized financial journal. Even the largest corporations are constantly issuing statements showing their semiannual, quar-

terly, and monthly earnings. These statements are frequently accompanied by comments of officers as to whether dividend requirements have been met. A common expression found in financial items is that the "quarterly dividend has been earned." Furthermore, surplus earned in prior years is often permanently invested in fixed assets, whereas current earnings may be found in cash or in liquid assets capable of distribution, and in many cases corporations *must* look to their current earnings if any distribution is to be made.

Indeed it is unnecessary to go beyond the record in the present case to show that dividends are paid out of current earnings. In 1915 the Phelps Dodge corporation earned $5,623,523.89 (p. 24). In 1916 it distributed $14,625,000. Its earnings for that year were $17,750,621.67. In 1917 its earnings were $16,742,487.06, and its distributions $14,400,000. In its statement to stockholders it speaks of its "regular dividends and extras" (p. 55) declared and paid in 1917. "Extra" dividends, it is well known, are dividends declared and paid when earnings are high and are earmarked as such in order that stockholders may realize that they are paid solely on account of high earnings and are not to be considered as part of the regular dividend policy of the company.

That dividends may be and commonly are declared and paid out of current earnings has been

recognized by this Court. In *Lynch* v. *Hornby*, 247 U. S. 339, this Court, at page 344, said:

> Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation.

IV

It is also suggested that a declaration of dividends out of current earnings is illegal under State laws forbidding the declaration of dividends except from "surplus profits." (Respondent's brief, page 38.)

If during the year a corporation makes a profit on a particular transaction, and its capital is unimpaired, the amount of this profit is surplus. It may not appear in the so-called surplus *account* of the corporation, if there is one. It may be in its "cash" account or "earnings" account or some other account. As long as it is retained by the company it is surplus and also an undivided profit in the exact and literal meaning of this term. If the corporation continues to operate at a profit it acquires or accumulates further surplus, which, as admitted by the court below (p. 105), is literally its most recently accumulated undivided profits

or surplus. This surplus is legally as available for distribution to stockholders as the surplus account, if any, standing on the books. If the company wishes to make a distribution to its shareholders it may lawfully distribute up to the amount of any surplus standing on its books, plus the amount of any surplus acquired since the books were closed, subject to the provision that such distribution be made in good faith, and that reasonable provision be made to take care of future liabilities. This is all that is held by *People ex rel Jamaica Water Supply Co.* v. *State Board of Tax Commissioners,* 128 App. Div. (N. Y.), 13, cited by respondents at page 38 of their brief, and it is unquestionably correct. How the corporation treats this distribution on its books is not material; certainly not under a statute providing that all distributions must be deemed to have been made from the most recently accumulated surplus. Under this language the distribution must clearly be allocated to the most recently acquired earnings.

V

It is argued by respondents, as well as by the court below (respondents' brief, pages 30–34), that because a corporation, like Phelps Dodge Corporation, is required to take inventories at the beginning and the end of the year in order to determine its *net income* for that year for income-tax purposes, any earnings in the intermediate course of a year are only prospective earnings. This argument

is fallacious, and this fallacy pervades a good part of the brief for respondents. The distinction between statutory net income and actual corporate earnings has already been pointed out. It has likewise been shown that because the statute imposes a tax on an annual net income there is no reason to suppose that it contemplates an annual closing of books or prescribes an annual fiscal period. A corporation may close its books as often as its business needs require, for aught that appears in the Revenue Acts. It is required only that in computing net income for the purpose of taxation the gross income and the deductions shall be determined on an annual basis. But this does not affect the question whether a corporation has earnings at any one time. If, for instance, Phelps Dodge Corporation sold 1,000,000 pounds of copper on July 1, 1917, at 10 cents a pound over the cost of production, on that date it had a profit of $100,000, which profit was surplus available for dividends.

The case is the same as the case of a corporation owning only one piece of realty, which it sold at a profit of $100,000, as to which there could be no dispute. The fact that due to a fall in the market price of copper the closing inventory as of December 31, 1917, may be so low that the net income for the year may be greatly reduced or completely wiped out does not mean that this profit has in some way or other been retroactively destroyed so that on July 1st it was not a profit. It would be just as sensible to say that profits earned in the previous

year had been wiped out. What has happened is that a subsequent loss has reduced the annual net income in the way that a subsequent fire or mine disaster might do.

No more does the fact that the corporation balances its books at stated intervals have any relevancy. Whether profits exist at any time is a question of fact whether or not the corporation has closed its books. If a subsequent loss takes place before the books are closed, this does not make a distribution of profits which actually existed a distribution of capital, or a tax on such distribution a tax on capital.

VI

In an attempt to avoid the absurdities and inequalities inherent in their construction of the statute, respondents and the *amici curiae* both argue that the high war taxes on the supposed favored class of taxpayers are not taken off, but only postponed. It is argued (Respondents' Brief, page 61) that this postponement was only until January 1, 1918, three months after the Act was passed, despite the fact that the tax on distributions made in January, 1918, would not be due until June, 1919. It is also argued (Respondents' Brief, page 69) that if the Revenue Act of 1917 had continued in force when the tax rate came to be reduced, these taxpayers would still be paying the high rate. But this is to pile inequality on inequality, and to impute to Congress the capricious

and unreasonable intention of imposing pre-war rates when war rates were required, and war rates when the same were no longer necessary. There is no reason for such discrimination. To refrain from imposing war rates on distributions by corporations which had no war profits, and therefore must be distributing pre-war earnings, might appeal to the congressional sense of fairness in view of the disturbed condition of business in 1917. But to discriminate between taxpayers according to the previous financial condition of corporations making war profits and paying distributions is utterly unreasonable and absurd.

VII

Instances are cited (Respondent's Brief, pages 29, 30, 36–39) in which the words "surplus" and "undivided profits" are used in the sense of "surplus account," and "undivided profits account." It is not denied that these words may be used in this sense when the context requires it or when the word "account" is added. It is denied that this is the well-settled or only meaning, or that in strict accounting parlance "the most recently accumulated undivided profits or surplus" are not literally the most recent current earnings.

In particular the explanation (Respondent's Brief, pages 39–41; Brief of Messrs. Murray and Tweed, pages 16, 17) of the clause in Section 207 (*a*) of the Revenue Act of 1917, excluding from paid-in or earned surplus and undivided profits used or

employed in the business "undivided profits earned during the taxable year," as intended to exclude only such undivided profits as come into existence at the end of the taxable year, overlooks the use of the word "earned," and the provision that invested capital must be "averaged monthly." If only undivided profits appearing on the books at the close of the taxable year were intended, it would have been sufficient to say "exclusive of undivided profits of the year." Furthermore, there would be no reason for the exclusion, since only surplus and undivided profits *used or employed* in the business were included. The only undivided profits earned during the taxable year which could be used or employed in the business during the year were the current earnings, and not the undivided profits appearing at the end of the year, and it is clear that it was such earnings that Congress had in mind when it used the phrase "undivided profits."

VIII

It is stated at page 69 of respondent's brief that if the government had adopted the construction of Section 31 (*b*), for which respondents contend, it would have secured greatly increased excess-profits taxes from corporations. This is true and shows the importance of the rule that in determining the meaning of a statute the construction of the executive department charged with its enforcement will be given great weight. The Treasury Department had the duty of determining in the first instance

which construction of Section 31 (*b*) should be adopted. One construction would have increased the income taxes of stockholders, the other the excess-profits taxes of corporations. The department adopted the first construction, and thousands of corporations (including Phelps Dodge Corporation) received the benefit by the adjustment and closing of their excess-profits tax returns upon this basis. Many millions of dollars of taxes were collected and refunded under this construction.

Many years after the tax became due, and after the statute of limitations on the collection and refund of taxes has expired, this Court is asked to set aside the departmental construction in the interest of one class of taxpayers. It is clear that in a case like this the construction should not be overruled unless it is entirely unwarranted by the words of the statute.

This case is analogous to *Lincoln Chemical Co.* v. *Edwards*, 289 Fed. 458, in which a departmental construction of the Revenue Act of 1917 favorable to one class of taxpayers was contested by a taxpayer adversely affected thereby. The same court which heard the case at bar below at page 462 said:

> The construction given to an Act of Congress by a department of the government charged with its execution, is not controlling upon the courts as the department is not authorized to exercise the judicial function, but it is entitled to great consideration when the meaning of a statute is doubtful. *United States* v. *Hermanos y Compania*, 209 U. S.

337, 339; *United States* v. *Healey,* 160 U. S. 136; *Robertson* v. *Downing,* 127 U. S. 607. And the consideration given to such construction is particularly weighty in the case of statutes levying impositions where the construction had been favorable to the persons affected. *State* v. *Orleans Parish Bd. of Assessors,* 52 La. Ann. 223; *Attorney General* v. *Newborn,* 21 N. C. 216.

It is submitted that this rule is particularly applicable to the case at bar. The construction adopted by the Treasury Department has been favorable to a large class of taxpayers. It should not be overruled unless it is clear that the contrary construction would be sustained against the objection of taxpayers adversely affected thereby, and unless it is clear that the departmental construction is clearly contrary to the intention of Congress.

CONCLUSION

For the above reasons the judgment of the Circuit Court of Appeals for the Second Circuit should be reversed and the judgment of the District Court reinstated.

Respectfully submitted.

JAMES M. BECK,
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Special Assistants to the Attorney General.

APRIL, 1925.

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In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 129

WILLIAM H. EDWARDS, COLLECTOR OF INTERNAL REVENUE, petitioner

v.

ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER IN REPLY TO SUPPLEMENTAL BRIEF FILED BY RESPONDENTS BY PERMISSION OF THE COURT

The only question in this case is the rate of tax to be applied to the sum of $328,400, the amount of two dividends received by Dr. Douglas from Phelps Dodge Corporation on September 28th and December 28th, 1917. During the year 1917 the corporation declared and paid in dividends amounts representing 32% of its capital—four regular dividends of 2½% each, one extra dividend of 3½%, one

extra dividend of 5½%, two extra dividends of 2½% each, *and two dividends of 3% and 5%, respectively, Dr. Douglas's share in which are the dividends now under consideration.*

In his annual report to the stockholders dated February 28, 1918, the president of the corporation, confirming a previous statement under date of January 29, 1919, pointed out that the dividend paid in March, 1917, was declared and paid out of the profits accrued during the year 1916 and that the other three regular and extra dividends were paid out of earnings for the year 1917, while the two dividends under consideration were declared to be "a distribution from the reserve for depletion."

Dr. Douglas filed an income-tax return upon the basis of this report (Record p. 75), returning all the other dividends as taxable at the rates for the years in which they had been reported as earned, but claiming that the two dividends now in dispute were not taxable at all inasmuch as they were capital distributions. The Commissioner of Internal Revenue, however, refused to allow these dividends to be exempt from tax, and held them to be taxable at the 1917 rates, because the earnings of the corporation during the year 1917 were beyond question, as is now conceded, sufficient at the time to pay them. The District Court sustained the Commissioner. The Circuit Court of Appeals sustained the District Court to the extent of holding that the dividends could not be regarded as capital

distributions, but differed with the District Court in holding that they were taxable at the 1916 rates. To review the judgment of the Circuit Court of Appeals upon this latter point, the government obtained this writ of certiorari. No cross writ was asked. Therefore the sole question before this court is, Were these dividends, to pay which the corporation had on hand current earnings at the time they were paid, taxable as income of Dr. Douglas at the rates prevailing in the year when he received them, or at the rates prevailing in the year before he received them?

I

Respondents contended at length in their main brief that under Section 31 (b) of the Revenue Act of 1917 dividends may not be allocated to the earnings of the year in which paid for the reason that corporate directors do not know in the intermediate course of the year what the earnings are. It was suggested upon the argument that this supposed difficulty might be overcome if the method of allocation was to the earnings as finally determined at the end of the year, and that dividends, in so far as they did not exceed such earnings, should be taxable at the rates prevailing in the year in which paid, and that only the excess, if any, should be allocated to surplus accumulated in prior years and taxable at the rates then prevailing. This suggested method differs somewhat from the method

adopted by the Treasury Department, which requires allocation to the earnings of the year in which paid unless it can be shown that at the time of payment the earnings were insufficient.

The only question to be decided by the Court in this case is whether Section 31 (b) requires the allocation of dividends to earnings of the year in which paid and taxation of the same at the rates prescribed for that year or whether such allocation must necessarily be to surplus accumulated in some prior year. It is conceded that at the time of making the distributions in question Phelps Dodge Corporation had earnings more than sufficient to pay the same. It is also admitted that its earnings for the year exceeded its distributions by more than $2,000,000. It is therefore immaterial whether the method of allocation should be that adopted by the Treasury Department or that suggested on the argument. If 1917 dividends are to be allocated to 1917 earnings, the distributions here involved are taxable to Dr. Douglas at 1917 rates.

II

It is submitted, however, that the suggested method of allocation is nevertheless allowable under Section 31 (b). The statement of the House Committee, quoted at page 36 of the main brief for petitioner, seems to favor it. There is nothing in the legislative history of this section which in any way negatives it. In referring to this legislative history, respondents again fall into an error which

pervades their main brief. It is stated (Respondents' Supplemental Brief, pp. 4, 5):

> "The net income of the year in which such distribution is made" is necessarily surplus arrived at at the close of the year. Congress, therefore, by eliding all reference to this fund in the bill as passed, conclusively expressed its intention that intermediate distributions made in 1917 should not be so allocated.

The premise of this argument is false, and the conclusion is therefore erroneous. As petitioner has repeatedly pointed out, "net income" of the year "is not necessarily" surplus arrived at at the close of the year. As an illustration of this point, suppose that an investment corporation holding only tax-exempt securities receives an income therefrom during the year of $1,000,000. It has no net income, but it has "surplus arrived at at the end of the year" of $1,000,000. Suppose, again, another corporation having incurred a large income tax for the year 1916 receives through changed business conditions in 1917 an income only barely sufficient to pay the tax. Such a corporation has a "net income," since the tax paid is not allowed as a deduction, but since it has been compelled to pay out all of its 1917 earnings for its 1916 tax, it will have no surplus at the end of the year. Congress by eliding the reference to "net income" from the Senate bill did not exhibit an intention that dividends should not be allocated to surplus at the end

of 1917, but merely eliminated a phrase which in many cases would have defeated its purpose.

III

There is nothing in the context of Section 31 (b) which necessarily precludes the construction that the method of allocation should be by reference to the earnings as finally determined at the close of the year. It must be borne in mind that Section 31 (b) is not addressed to corporations and directors, but to stockholders who are returning their dividends for taxation. It prescribes the rate of tax which they shall pay thereon. If Congress intended that distributions made in 1917 should be taxed at 1917 rates, if the earnings of the corporation for the year were sufficient therefor, it is possible to hold that all distributions up to the amount of the earnings as determined at the close of the year should be taxed at 1917 rates, and that only the excess should bear the lower rates prescribed for some prior year. This is consistent with the scheme of the statute which clearly contemplates that dividends shall be allocated to surplus of prior years only to the extent that such allocation is necessary, and that the profits of the later and higher tax years shall be drawn upon first. The statute is addressed to the individual at the time of computing his tax, and at that time "the most recently accumulated undivided profits or surplus" is the surplus determined at the close of the

preceding year, the year in which the income was received. Furthermore, this method coincides with the accounting practice of a large number of corporations, which do not immediately charge dividends to preexisting surplus but hold them in suspense until the end of the fiscal period when any excess of earnings over distributions is credited to surplus and any excess of distributions over earnings charged against it.

IV

Respondents argue that this method of allocation defeats the manifest purpose of the act to induce directors to declare dividends at lower tax rates. There is obviously no purpose to induce directors of corporations making profits during war years to declare prior surplus at lower tax rates. The whole scheme of Section 31 (b) shows an intention to prevent that very thing. The only directors which the statute may attempt to induce to declare dividends at low tax rates are directors of corporations which were not making profits during the war, who, if the stockholders were compelled to pay war rates, would hesitate to draw upon the surplus accumulated when the tax rate was low in order to pay dividends. It is said that if all dividends are held in suspense, directors and stockholders can not know at the time of declaration to what fund such dividends should be charged or what tax rate they will bear. This is to assume in the case of directors of nonprofit-making corporations gross ignorance

of the affairs of their companies, which can hardly have existed in fact. In the case of other corporations there is no reason why they should not know at the time of declaration. Congress certainly did not intend that distributions should be made only when it was apparent that the stockholders would not have to pay the regular rates thereon.

V

There is nothing in the method of allocation under discussion which in any way collides with state laws forbidding dividends to be paid out of anticipated profits, or, what is the same thing, out of capital. If it be firmly grasped that Section 31 (b) is not directed to corporations or directors, does not prescribe or purport to prescribe how or when dividends shall be declared, does not authorize or purport to authorize any act or thing forbidden by state laws, but is merely a rule of law addressed to individual stockholders telling them the rate of tax which they shall pay on income received in the form of corporate dividends, much of the confusion pervading the briefs for the respondents will be dispelled. In no conceivable way can a statute commanding an individual who has received dividends from a corporation in the year 1917 to pay a tax at a certain rate on that part which is not in excess of his proportionate share of the earnings as determined at the end of the year, and a different rate on the excess, if any, collide with any state law forbidding the dissipation of

corporate capital through the payment of dividends.

VI

It is stated by respondents that the suggested method of allocation is inconsistent with the method adopted by the Treasury Department. It is true that the Department has not adopted the method of allocation by reference to the earnings as ascertained at the end of the year, but the precise method of allocation is not important here. The only question is, Should the distributions in question be allocated to 1917 earnings or Phelps Dodge Corporation and taxed to Dr. Douglas at 1917 rates, or does Section 31 (b) require that they be allocated to 1916 surplus and taxed at 1916 rates? On this question the long-continued and consistent construction of the section by the Department that dividends are to be allocated to current earnings is of great weight, in view of the large number of returns which have been settled on this basis and the large number of taxpayers who have received the benefit of it. On this fundamental question the departmental method of allocation and the suggested method agree. The possibility of this suggested method of allocation is an argument in favor of the construction of Section 31 (b) for which the petitioner contends. If the method of allocation adopted by the department should appear to the Court too complicated, the fact that a simpler method is possible under the statute is an addi-

tional reason for adopting the construction of Section 31 (b), which requires the allocation of dividends first to 1917 earnings and the taxation of the same at 1917 rates before resort may be had to the surplus of prior years with taxation at the much lower rates prevailing in those years.

WILLIAM D. MITCHELL,
Solicitor General.

ALFRED A. WHEAT,
RICHARD S. HOLMES,
Special Assistants to the Attorney General.

NOVEMBER, 1925.

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No. 524

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1924

William H. Edwards, Collector of Internal Revenue, Petitioner

Archibald Douglas, George Norman, and Edmund Coppin, as Executors of the Estate of James Douglas, Deceased, Respondents.

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

[illegible]

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1924.

WILLIAM H. EDWARDS, Collector of Internal Revenue, Petitioner

—against—

ARCHIBALD DOUGLAS, GEORGE NOTMAN, and EDMUND COFFIN, as Executors of the Estate of James Douglas, Deceased, Respondents.

No. 524

The petition and brief of the learned Solicitor General present considerations and arguments which would have been relevant and perhaps persuasive if addressed to the proper committees of Congress pending the passage of the 1917 Revenue Law. However, they have little bearing on the question of what the law as finally passed by Congress really means. The sole question in this case is whether, under Section 31 (b) of the 1917 Revenue Law, 1917 dividends should be deemed payable out of 1917 earnings, or out of an entirely different fund, called the "most recently accumulated undivided profits or surplus". The most striking thing

about the Government's argument is the fact that it absolutely fails to mention the main ground on which the Circuit Court of Appeals based its decision; namely, *the legislative history of the* 1917 *Law.* It does not even attempt to meet the argument that while the bill passed by the Senate clearly allocated 1917 dividends to 1917 earnings and taxed them at 1917 rates, the law finally passed by Congress omitted the Senate's language which clearly so allocated them, deliberately abandoned the Senate's plan, and allocated them to a fund which a few days earlier was recognized as an entirely different one; namely, the *"most recently accumulated undivided profits or surplus"*. This was the determining point in the case, and it is the sole point which the Government fails to discuss.

On behalf of the respondents, we submit the following:

I.

The record fails to disclose any grounds for granting the writ.

This court has repeatedly announced that the writ of certiorari should be "exercised sparingly and with great caution": that it is "solely questions of gravity and import" that justify its issuance. To quote its opinion in Lau Ow Bew, Petitioner (141 U. S. 583 at 587).

> "The inquiry upon this application, therefore, is whether the matter *is of sufficient*

importance in itself, and sufficiently open to controversy, to make it the duty of this court to issue the writ applied for" (Italics ours).

We contend that none of these grounds appear in the instant case.

It is not asserted:

(a) That there is any matter in this case affecting the interests of the Nation in its internal or external relations.

(b) That there is any conflict of law on the question sought to be reviewed between the Circuit Court of Appeals below, and any other Circuit.

(c) That there is any similar conflict of law between the decisions of the Federal Courts and that of a State Court in the Second Circuit or in any other Circuit.

(d) That the matter involved is of sufficient importance in itself, as distinguished from its importance to the litigants, to require this court to issue the writ.

(e) There is no question of fact or inference of fact presented—all the facts were stipulated.

But it is claimed by the government that the writ should be granted because there is a question of construction of the Internal Revenue Law of 1917 before the court, and this involves a large amount of refunds in this and other suits pending, and it is highly desirable that a uniform rule should be established by this court.

We discuss these contentions in Point IV below.

NOR IS THERE ANY AMBIGUITY IN THE ACT NECESSITATING JUDICIAL CONSTRUCTION

The sole question sought to be raised is (we quote from the petition, p. 3):

> "Under section 31 (b) of the Revenue Act of 1917 are distributions made by a corporation to its shareholders in the year 1917 taxable to the shareholders at the rates prescribed by law for the year 1917, if the corporation has earnings for that year sufficient to pay them, or must they be allocated to the surplus accumulated in prior years and bear the lower rates of taxation prescribed for prior years?"

We deny that there is any ambiguity in the section of the 1917 *Act requiring judicial construction. It is our contention that this act, in the phraseology used, in its gramatical structure and in the light of its legislative history, clearly allocates all dividends paid in* 1917 *to prior corporate surplus as distinguished from current earnings, and subjects such dividends to the lower tax rates then prevailing.*

The Act and its history, when examined, will so clearly establish the intention of Congress, that this court will be satisfied that no writ should issue.

II.

THE LEGISLATIVE HISTORY OF SECTION 31 (b) ESTABLISHES OUR POSITION.

Bearing in mind the established rule that in case of doubt taxing statutes are to be construed against the Government (Gould v. Gould, 245 U. S. 151; U. S. v. Merriam, 263 U. S. 179), and the equally well established rule that formal reports of committees having in charge pending legislation, as well as changes in the bill in the course of its passage, may be consulted in order to determine the meaning of a statute (U. S. v. St. Paul, etc. R. Co., 247 U. S. 310; Duplex Company v. Deering, 254 U. S. 443, 474), the present case presents no difficulty which requires a review by the Supreme Court.

The omission of all reference to the Legislative History, either in the petition or brief of the Solicitor General, requires a brief statement of it here.

Section 31 (b), originated in the Senate. Its legislative action may be graphically presented by paralelling the Section as *proposed* by the Senate and the same Section as finally passed by Congress, as follows:

Section 31 (*b*) *as proposed by the Senate.*	*Section* 31 (*b*) *as finally passed.*
"Any distribution made to the shareholders of a corporation in the year nineteen hundred and seventeen, or subsequent	"Any distribution made to the shareholders or members of a corporation, * * * in the year nineteen hundred

tax years, shall be deemed to have been made FROM THE NET INCOME OF THE YEARS IN WHICH SUCH DISTRIBUTION IS MADE OR IF SUCH INCOME IS INSUFFICIENT, from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the shareholder for the respective years in which *EARNED BY THE CORPORATION*, joint stock company or association, or insurance company, and shall be taxed to the shareholder at such rate prescribed by law for *(SUCH YEAR)*".

and seventeen, or subsequent tax years, shall be deemed to have been made from the most *recently accumulated undivided profits or surplus,* and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus *were accumulated by the corporation.*"

NOTE: Words in caps omitted in Law.

This shows a most significant change made in the proposed law by the Conference Committee and afterwards adopted. The Committee eliminated from Section 31 (b), the words "FROM THE NET INCOME OF THE YEARS IN WHICH SUCH DISTRIBUTION IS MADE, OR IF SUCH INCOME IS INSUFFICIENT". The Section as proposed by the Senate, without elision, was clear and unambiguous. If these words, subsequently omitted,

had remained in the Statute as passed, it would have expressed in most apt phraseology the very meaning which the Solicitor General now claims should be attributed to the Act. If such had been the case, any argument to the contrary by respondents would have been futile. The very words of the Section would, in unmistakable language, have allocated dividends declared in 1917 to the current earnings or net income of the year 1917 "if sufficient," but if not, then to the "most recently accumulated undivided profits or surplus" as it stood at the beginning of the year 1917.

This, it will be seen, is exactly the construction of the Act as passed for which our learned opponent contends. Unfortunately for his argument, Congress struck from the proposed act the very words which would have supported this contention. It elided from the Section all reference to the net income of the years in which such distribution is made. Congress thereby evinced beyond question its clear purpose to allocate dividends to another and different fund, to wit, "most recently accumulated undivided profits or surplus" of the prior fiscal period.

The Solicitor General attributes to this change in the proposed act no significance. He would have this Court construe the Section as passed, exactly as if no change had been made.

In the words of Chief Justice Taft:

> "Where an amendment changes the phraseology of a former Act, it will be presumed that it was the intention to make a corresponding change in its meaning." (U. S. v. Bashaw, 152 U. S. 436).

Congress certainly did not strike out these words in the belief that the phrase "net income of the years in which such distribution is made" was synonymous with the phrase "most recently accumulated undivided profits or surplus". The Act as proposed shows that the former phrase was used in contradistinction to the latter. It allocates distributions to the latter funds, only provided the *former "is insufficient"*. If synonymous, how could the former fund be insufficient, yet the latter suffice?

Nor can it be argued that Congress intended to make the statute ambiguous.

It therefore follows that Congress deliberately left out all reference to the current earnings or the "net income of the years in which such distribution is made", *in order that no distribution should be allocated to that fund.* The law-makers abandoned their original intention of attributing dividends declared in 1917 in the first instance to current earnings. In order to "encourage distributions" it was provided that they be attributed to undivided profits or surplus in the inverse order of its accumulation in prior years and bear the lower tax rates then prevailing.

The same abandonment of the original intention of the Senate appears from other changes made in the paragraph. While Section 31 (b) as proposed provided that 1917 dividends should constitute income of the shareholder for the year *"IN WHICH EARNED BY THE CORPORATION"* and should be taxed at the rate prescribed for *"SUCH YEAR"*, the law as passed provided that they should be taxed at the rates prescribed *"FOR THE YEARS IN WHICH SUCH PROFITS OR SURPLUS WERE*

ACCUMULATED". Again therefore appears the deliberate omission by Congress of all reference to *earnings.*

As Judge Mayer aptly says in delivering the opinion of the Circuit Court of Appeals:

> "While the Senate Finance Committee and Senate intended that the dividends declared in 1917 should be deemed to have been paid first from such net income as might be earned in 1917, it is plain that this program was not satisfactory to the Conference Committee. * * * *The real point of this legislative history is that the legislature was not, in this regard, dealing with current earnings, and by the most obvious procedure had eliminated current earnings from consideration as affecting the rate at which the taxpayer was to be taxed.*

And now the significance of the omission in the Solicitor's petition and argument of all reference to this legislative action becomes apparent. He is unable to meet the force of this argument growing out of this Congressional action. While the Bill as passed by the Senate clearly allocated 1917 distributions to current earnings and taxed them at 1917 rates, the law as finally passed deliberately abandoned this purpose and conclusively allocated them to the undivided profits or surplus of prior years.

Analyzed, this becomes:

III.

A CASE OF DEPARTMENTAL LEGISLATION

This case therefore resolves into an attempt of the Treasury Department to incorporate *by regulation* into the 1917 law a provision which Congress deliberately and specifically struck out. It is "Departmental legislation," which the court has frequently condemned.

In endeavoring to support this attempt, the Solicitor General, by a series of arguments, savoring of subtlety, strains to have the Court extend by implication, conjecture and inference, the plain words of a taxing statue so as to bring within the scope of the high surtaxes of the 1917 Act, distributions never so intended by Congress. Much of this argument is not addressed to the construction of the act itself, but is quite apart from its clear and obvious meaning. These arguments might have some place if adressed to a Congress Committee pending the passage of the Act. They have no application to its construction after its enactment.

Again, many of these arguments are predicated upon definitions of the words "profits" *simpliciter*. They ignore entirely the definite phrase of the act "most recently accumulated undivided profits or surplus".

This Court, in many of its opinions, has recognized that these phrases have a fixed significance and refer to a surplus definitely ascertained at the end of a fiscal period. Thus in Eisner v. Macomber, 252 U. S. 189 at p. 209, Mr. Justice Pitney said:

> "If profits have been made and are not divided they create additional bookkeeping, liabilities under the head of 'profit and loss', 'undivided profits', 'surplus account' or the like."

See also dissenting opinion of Mr. Justice Brandeis, in the same case.

> "It is a matter of common knowledge and indeed an obvious fact that accumulated undivided profits or surplus cannot be estimated without investigation or some appropriate method of accounting or calculation." (See Opinion, Court below).

That the above unmistakable conclusion is fair and reasonable further appears from certain well known facts, well expressed by the Court below (Italics ours):—

> "*A person or a corporation really does not know what are the profits of his or its business until the conclusion of some fixed period, whether it be a calendar or fiscal year.* If a corporation on February 1st of any year were to distribute in dividends profits made in the January immediately preceding, it might find that all these profits would, for one reason or another, be wiped out in March of the same year. If, one the other hand, the undivided profits or surplus accumulated in January were not distributed, it would be a misnomer to say that on February 1st of the same year there was on hand accumulated undivided profits or surplus for the month of January.

> In literal language, that might be true, because the undivided profits or surplus of January would have been accumulated in the sense that they had not been distributed. In taxing statutes, however, as in most other matters regulated by law, we do not deal in abstractions; and *an income tax statute usually provides for fixed periods as the measure of calculation and obligation, and this is because business, large and small, is done that way and no man in active business can tell where he stands financially for a given time, whether it be a calendar year or fiscal year or some other definite period, until he shall have arrived at the end of that period and is then able on facts known or ascertainable to determine, with reasonable approach to accuracy, what is his financial condition.*"

If Congress deliberately incorporates therein words having a recognized signification in business, they must be deemed to have used these words in that sense.

See *Southerland on Statutory Construction,* 2nd Edition page 777.

Thus we contend that the Act is clear, both in the accurate phrases used and when read in the light of the legislative history of the Section as envincing Congressional intention. It follows that there is no occasion for the interposition of judicial construction and no question sufficiently open to controversy requiring this court to issue the writ prayed for. This would seem to dispose of the application.

Certain other arguments, however, made by the Solicitor General require a brief comment.

IV.

OTHER ARGUMENTS OF PETITIONER DISCUSSED

The Solicitor argues that the writ should be granted because of the large amount of refunds involved in this and other suits pending, and alleges the payment of such refunds may seriously affect "the fiscal policy of the Government."

While respondents are at a disadvantage in the matter of criticising circumstantially the accuracy of the above general statement, we submit that on its face it appears exaggerated. It is difficult to believe that, over six years after the 1917 taxes were paid, any substantial refunds based on the decision in this case will "seriously affect the fiscal policy of the Government". Even if the amount involved be large, it will be relatively insignificant in comparison with the total taxes collected for the year in question.

The recovery of 1917 refunds can only be had by those taxpayers who have within the statutory period, now long since expired, preserved their rights by filing claims for refund and commencing suit. The number of such taxpayers and the amounts finally recoverable by them we feel sure are comparatively small. In its zeal for the granting of the writ, the Government has not substantiated its vague statements by actual figures from data within its possession. This omission is significant.

We in passing comment on the fallacy of the argument. The amount of tax collected by the Govern-

ment has no bearing on a construction of the act in question. If the construction is correct for the other reasons advanced, then the collections are legal. If illegal, then the amount thereof does not justify their retention.

As to the Government's contention that it is important that a uniform rule be prescribed on this point, it is sufficient to say that the refusal to grant the writ will promptly and effectually "prescribe the uniform rule" desired.

Further, the Solicitor argues in his brief that the act as construed by the Court below, would differentiate between corporations closing their books annually and those closing their books semi-annually or quarterly, and that, therefore, the rate of taxation might depend on the chance time of closing the books in particular cases. This argument mistakes plaintiff's contention. A corporation does not have a series of surplus during the year, merely because it closes its books quarterly or monthly. There is only one surplus for that year, arrived at by a balancing of the books *at the close of that year.* Income cannot be defined or arrived at *except over a period of time, and that by business custom and revenue laws is defined as a year.*

The entire structure of these Revenue Acts rests on a yearly period. It is imperative, therefore, with this system of taxation, that "the surplus and undivided profits" to which Section 31 (b) attributed distributions should be those determined on this yearly basis.

It is also suggested that the construction given by the Court below would lead to unjust and absurd results. The Solicitor's ingenious mind has devised

a number of such fanciful cases. These, however, are not attributable to the construction claimed by the plaintiff. As Judge Mayer in the court below well-said:

> "Experience demonstrates that however carefully framed, a tax statute rarely, if ever, can be drawn with such extraordinary foresight that it will provide for every possibility."

It is further urged that the construction of the Act by the Court below "leads necessarily to the conclusion that Congress intended to discriminate in favor of income derived from dividends and against income derived from interest, rent and personal effort".

But this alleged discrimination exists if either construction is adopted. Congress expressly exempted dividends from normal taxes, and gave a lower rate to dividends when paid out of surplus earned in years prior to 1917 "to encourage these companies to distribute their annual earnings." (See Conference Report, Congressional Record Page 8690). This avowed purpose would fail unless the Act created against other forms of taxable income the very discrimination which the learned Solicitor brands as "so unjust and so baseless".

V.

THE PETITION FOR WRIT OF CERTIORARI SHOULD BE DENIED.

Respectfully submitted,

MATTHEW C. FLEMING,
ARCHIBALD DOUGLAS,
PAUL ARMITAGE,
EDWARD HOLLOWAY,
Of Counsel.

September, 1924.